Nos. 97-826, 97-829, 97-830, 97-831, 97-1075,
97-1087, 97-1099 and 97-1141

In The
Supreme Court of the United States

OCTOBER TERM, 1997

AT&T CORP., *et al.*,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

U S WEST, INC., *et al.*,
Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Respondents.

**On Writ of Certiorari to the
United States Court of Appeals
for the Eighth Circuit**

**OPENING BRIEF OF
RESPONDENT/CROSS-PETITIONER
U S WEST, INC.**

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May 18, 1998

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QUESTIONS PRESENTED

1. Whether the FCC violated the Communications Act of 1934, as amended by the Telecommunications Act of 1996 ("Act"), by requiring incumbent telephone companies to sell network services and capabilities as unbundled network elements under section 251(c)(3), even where an incumbent's competitors have no need to obtain those services and capabilities from the incumbent because equivalents are readily available from sources other than the incumbent.

2. Whether the FCC violated the Act by concluding that the term "network elements" encompasses not only physical facilities used in the delivery of calls, but virtually every productive asset of an incumbent telephone company's business, including human operators, software used for business functions such as billing, and services.

3. Whether the FCC violated the Act, and in particular its express distinction between resale and unbundled network elements, by requiring incumbent telephone companies to sell as unbundled network elements under section 251(c)(3) finished retail services such as caller I.D. and call forwarding, when the same services must be made available for resale under section 251(c)(4).

4. Whether the FCC violated the Act by requiring incumbent telephone companies to sell to competitors who possess no facilities of their own access to *all* the network elements associated with a particular retail service, not at the statute's discounted rate for resale, but at the cost-based rate reserved for competitors who purchase access to individual network elements to combine with their own facilities.

5. Whether the FCC violated the Act's requirement that incumbents provide their competitors with unbundled

network elements "in a manner that allows *requesting carriers* to combine such elements," 47 U.S.C. § 251 (c)(3) (emphasis added), by mandating that incumbents do the work of combining elements purchased by requesting carriers.

6. Whether the FCC violated the Act by permitting new entrants to "pick and choose" individual terms from an incumbent's past and future interconnection agreements without accepting all of the contractual tradeoffs that originally accompanied those terms.

7. Whether the FCC violated the Act by asserting jurisdiction to regulate the rates and certain other terms of local interconnection arrangements despite the fact that Congress gave states authority to "establish" and "determin[e]" the rates for local interconnection arrangements (47 U.S.C. §§ 252(c), (d)) and provided that "nothing in this Act shall be construed . . . to give the [FCC] jurisdiction" with respect to intrastate matters (*id.* § 152(b)).

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, U S WEST, Inc. advises the Court that it has no parent companies. U S WEST, Inc. has the following non-wholly owned subsidiaries having outstanding securities in the hands of the public: Financial Security Holding, Ltd. and TeleWest PLC.

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OPENING BRIEF OF RESPONDENT/CROSS-PETITIONER U S WEST, INC.

STATUTORY PROVISIONS INVOLVED

Relevant portions of the Communications Act of 1934, as amended by the Telecommunications Act of 1996, appear at Pet. App. 93a-130a [1] and in the appendix to this brief.

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[1] "Pet. App." refers to the appendix to the petition for a writ of certiorari in *AT&T Corp. v. Iowa Utils. Bd., cert. granted,* No. 97-826 (Jan. 26, 1998), which has been consolidated with this case.

STATEMENT OF THE CASE

Providing a functioning local telephone service to consumers requires the coordinated use of a variety of facilities, equipment, and personnel. Some aspects of the business—for example, taking orders and sending bills—use readily available inputs such as computers and programmers, and thus are within the easy grasp of anyone with sound business skills and the necessary capital. The business also requires a network of specialized equipment, such as the switches that route calls and the wires that actually transmit the calls from one point to another.

Until the 1990s, it was widely assumed that each local market would support only one such network and that it would be uneconomical to build alternative facilities. In adopting the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("Act" or "1996 Act"), Congress reversed that assumption: It determined that deploying alternative networks to provide local services was no longer infeasible and that facilities-based competition therefore should be permitted and encouraged.

Underlying Congress' decision was the belief that potential new providers are now, or soon will be, able to build or acquire most of the components needed to provide local telephone service. To the extent that some facilities cannot be reasonably duplicated, Congress required incumbent carriers to share them with new entrants until the newcomers are able to obtain such equipment in the marketplace. In this way, Congress aimed to open the market for local telephone service to full and vigorous competition more quickly than if each new entrant had to complete its own network before offering service.

This case requires the Court to consider whether the FCC in its First Report and Order [2] fundamentally distorted Congress' scheme by rejecting the view that the

[2] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 F.C.C.R. 15499 (1996) ("Order" or "First Report and Order").

deployment of alternative facilities-based networks by competing local telephone service providers is now feasible and desirable. Specifically, the FCC required established carriers to share with their competitors not only facilities that remain difficult to duplicate, but *all* of their facilities, up to and including the entire network, and even new facilities that the carrier constructs in the future. The FCC also required the sharing of business functions that are not physical parts of the telephone network at all. And the FCC required incumbent carriers to perform the work of assembling their facilities into finished services on behalf of new competitors. These requirements collapse two distinct provisions of the 1996 Act, create opportunities for regulatory arbitrage that Congress plainly did not intend, and transform a regime designed to share facilities that are economically necessary for competition into one that grants virtually unlimited access to an incumbent carrier's entire business. In these and other respects, the FCC's Order is inconsistent with the 1996 Act.

A. Pre-1996 Regulatory Background

Before the 1990s, local telephone service was widely understood to be a natural monopoly. As explained in a leading treatise, "[t]he high cost of fixed plant, the steadily declining average cost of service, and the need for all customers to interconnect with one another made it seem both sensible and inevitable to have a single monopoly provider." Michael K. Kellogg, John Thorne, and Peter W. Huber, *Federal Telecommunications Law* 1 (1992). Regulation of the industry was "premised on the belief that service could be provided at the lowest cost to the maximum number of consumers through a regulated monopoly network." Pet. App. 131a (Order ¶ 1). Most states therefore granted an exclusive franchise in each local telephone service area. *See id.*; H.R. Rep. No. 104-204, at 49-50 (1995). The exclusive franchisees were known as "local exchange carriers" or "LECs."

Because there were no alternatives to the network facilities operated by LECs, regulatory authorities treated the facilities as quasi-public assets. LECs were regulated as "common carriers," meaning that they had to provide service to all requesting customers on a nondiscriminatory basis. As telecommunications technology became a crucial component of computer and information services, the FCC took steps to ensure for all potential competitors "nondiscriminatory access to and use of common carrier transmission facilities" that were "essential to the competitive provision" of such services. *Computer and Bus. Equip. Mfrs. Ass'n,* Report and Order, 93 F.C.C. 2d 1226, 1236 ¶ 32 (1983).

Similarly, the breakup of AT&T in the early 1980s was designed to put an end to alleged anticompetitive practices made possible by AT&T's "control over the local exchange facilities" that "were and are needed for interconnection purposes by AT&T's competitors." *United States v. AT&T,* 552 F. Supp. 131, 162 (D.D.C. 1982).[3] The theory was that long distance service was potentially competitive, but that the ability to compete depended on access to noncompetitive local facilities controlled by AT&T. To prevent AT&T from discriminating against its long distance competitors, AT&T was required to spin off its local exchange facilities to independent Bell Operating Companies, which in turn were required to provide access to all long distance and information service providers on a nondiscriminatory basis. *See id.* at 196. In short, the monopoly local exchange network could be used by everyone, and LECs were required to provide their essential service in a manner that would not favor one user over another.

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[3] *See also MCI Communications Corp. v. AT&T,* 708 F.2d 1081, 1133 (7th Cir.), *cert. denied,* 464 U.S. 891 (1983) (concluding that "AT&T had complete control over the local distribution facilities that . . . were essential for MCI to offer [competing long distance] service" and that "[t]he facilities in question met the criteria of 'essential facilities' in that . . . [i]t would not be economically feasible for MCI to duplicate [AT&T's] local distribution facilities").

In addition, states closely regulated the prices for local telephone service. State rate regulation established what was in essence a regulatory compact with each LEC. The LEC would effectuate state policies designed to promote "universal service"—that is, to make basic telephone service available to all customers at affordable rates. *See, e.g.*, H.R. Rep. No. 104-204, at 49-50 (1995). In return, state regulators would protect the LEC's opportunity to earn a reasonable rate of return on its investments. *See* Kellogg, et al., *supra*, at 429-31 (describing traditional "rate-of-return" regulation).

The result of this compact was a state-mandated rate structure in which prices for particular local telephone services were based more on policy considerations than on ordinary economic and market factors. Prices for some services—specifically, residential service and service in rural areas—were set artificially low, and prices for other services were set correspondingly high. For example, business customers generally paid substantially higher rates than residential customers, even though the costs of providing the two types of service are roughly the same. *See Federal-State Joint Board on Universal Service*, Report and Order, 12 F.C.C. Rcd 8776, 8784 ¶¶ 10-11 (1997). Because LECs were required to serve all customers and competing service providers were not permitted at all, there was no risk of a carrier disrupting this cross-subsidy pricing structure by serving only the most profitable customers. The system worked well, and residential customers received rates that were often substantially below cost.

The states conducted detailed periodic ratemaking proceedings designed to ensure that these rate structures continued to produce overall revenues sufficient to enable LECs to achieve reasonable rates of return. The opportunity to earn such a return, in addition to avoiding possible constitutional concerns, enabled the LECs to attract the capital needed to fund investments in their networks. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310

(1989) (utility must be permitted a rate that will allow it to "'maintain its financial integrity, to attract capital, and to compensate its investors for the risk [they have] assumed'" (quoting *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944))). Thus, the rate structures preserved the incentive and ability of LECs to invest in maintaining and improving their networks and services, which served the public interest in having a high quality and widely accessible telecommunications network.

B. The Telecommunications Act of 1996

In adopting the Telecommunications Act of 1996, Congress decided to end the monopoly in local telephone service and open up local markets to competition. Underlying this decision was Congress' rejection of the old assumption that local telephone service is a natural monopoly—that is, that it is inefficient to have more than one network to provide local service. Congress determined that, given the current state of technology, real competition among multiple providers of local telephone service with separate networks is possible and will benefit consumers. And Congress did not simply endorse the goal of competitive local service markets and leave to the FCC the task of managing the transition. Rather, the 1996 Act provides a detailed road map for reform.

The Act adopts specific measures designed to promote investment and innovation in telecommunications infrastructure by new entrants and incumbent LECs alike, resulting in vigorous facilities-based competition. But Congress also understood that developing alternatives to some network facilities controlled by incumbent LECs may be difficult, at least in the near term, and that as a result access to such facilities still may be essential to the effective provision of service by competitors. For that reason, Congress imposed a duty on incumbent LECs to share such facilities with other carriers so long as the facilities remain essential to the ability to compete and newcomers remain unable reasonably to build or acquire

them from alternative sources. Congress also permitted carriers that wished to compete without any facilities of their own to purchase the complete services of incumbent LECs and to resell them, but under a separate provision of the Act and subject to different pricing standards. Finally, to ensure that the onset of competition would neither undermine nor be undermined by universal service policies, Congress launched a process to reform the measures used to support universal service.

1. *The Act's Structure for Promoting Competition*

The Act opens the door to competition by expressly preempting state and local barriers to entry in all segments of the telecommunications services market, intrastate as well as interstate. 47 U.S.C. § 253. As a result, states may no longer grant exclusive franchises to provide local telephone service or otherwise arbitrarily limit participation in the market. Other carriers now have the legal right to build and operate local telephone networks in competition with incumbent LECs.

Because a customer is unlikely to subscribe to a new carrier's service unless he can call and be called by users of the incumbent LEC's network, the Act requires incumbent LECs to interconnect their networks with those of "any requesting telecommunications carrier." 47 U.S.C. § 251(c)(2). With interconnection, a carrier can build a network covering a small area—say, a single neighborhood—and rely on the incumbent to carry traffic to and from points outside that network. Thus, interconnection enables a new entrant to launch itself as a facilities-based competitor on a limited scale and then expand its operation over time. Incumbents may charge for providing interconnection, but their rates must be "based on the cost" of the service and "nondiscriminatory." 47 U.S.C. §252(d)(1)(A). The Act specifies that these cost-based rates "may include a reasonable profit." 47 U.S.C. § 252(d)(1)(B).

Congress wanted and expected that the removal of entry barriers and the right to interconnect with the incumbent's network at cost-based prices would generate effective facilities-based competition for local service. The Act's procompetitive framework was intended to "accelerate rapidly private sector deployment of advanced telecommunications and information technologies." H.R. Conf. Rep. No. 104-458, at 1 (1996) ("Conference Report"). That goal plainly envisions new carriers deploying their own advanced technology in competition with incumbent LECs. The Conference Report expressly endorsed the view that "meaningful facilities-based competition is possible." *Id.* at 148.[4] Thus, Congress' intention was to encourage robust competition among providers with separate networks, not competition in which all participants are dependent on a single network operated by a single carrier.

However, Congress also recognized that erecting a fully functional local exchange network is a substantial task. The Act therefore provides two distinct routes through which a carrier may begin to offer a competing local service without constructing a complete network of its own. One route is to obtain access to selected individual pieces of the incumbent LEC's network, called "unbundled network elements," which the new entrant may

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[4] *See also Communications Law Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce*, 104th Cong. 9 (1995) (statement of Rep. Schaefer) ("[The Act's approach to reform] rightly stresses a need for facilities-based competitors to lead the way in providing a true alternative to today's monopoly in the local exchange service. In fact, it is no exaggeration to say that the entire bill is premised on the existence of robust facilities-based competitors."); 141 Cong. Rec. H8465 (daily ed. Aug. 4, 1995) (statement of Rep. Goodlatte) ("[The telecommunications legislation] gives new entrants the incentive to build their own local facilities-based networks, rather than simply repackaging and reselling the local services of the local telephone company. This is important if the information superhighway is to be truly competitive.").

use to fill in gaps in its own unfinished network. 47 U.S.C. § 251(c)(3). The other is to purchase complete services from the incumbent LEC and resell them to end users, thus enabling the new entrant to compete without constructing any new network facilities at all. *Id.* § 251(c)(4).

a. The Unbundled Access Provisions of Section 251 (c)(3). Some of the specialized telephone equipment that was once expensive to duplicate is now, thanks to technological advances, not particularly difficult to build or acquire. (Switching increasingly falls in this category.) However, the provision of local exchange service also requires some facilities that the incumbent LEC has had in place for many years and that still may be difficult for competitors to duplicate in the short run. For example, developing widely available alternatives to the incumbents' "local loops," the wires running into each individual household, may be a gradual and expensive process. Congress recognized that, as a result, incumbent LECs may retain dominant control over some such bottleneck facilities for some time to come, at least in areas that are relatively costly to serve.[8]

Section 251(c)(3) seeks to address this issue and facilitate entry by new facilities-based competitors by enabling a competitor to lease selected "network elements" from the incumbent and to combine those elements with its own facilities in order to provide service. 47 U.S.C. § 251(c)(3).

[8] Alternatives are being developed even to the incumbent LECs' local loops. *See, e.g.*, "Section 706: An Opportunity for Broadband Competition Policy," Remarks of Gloria Tristani before the U S WEST Regional Oversight Committee (Apr. 27, 1998) (available at www.fcc.gov/commissioners/tristani/gtsspeech.html) ("Fixed wireless technology may someday provide a cost effective and reliable loop substitute. And cable lines are being upgraded to permit telecommunications and Internet access.") The difficulty of duplicating particular facilities has tended to decline over time as technology advances. The practicality of duplicating a facility also may vary with geographic location, depending on such factors as population density and terrain.

The statute requires an incumbent LEC to provide a requesting carrier with access to network elements "on an unbundled basis," "at any technically feasible point," and "in a manner that allows requesting carriers to combine such elements in order to provide . . . telecommunications service." *Id.* As the Conference Report explains, this provision means that new local carriers assembling their own networks, instead of needing a "fully redundant network in place when they initially offer local service," may begin to provide service using "[*s*]*ome* facilities and capabilities . . . obtained from the incumbent local exchange carrier as network elements." Conference Report at 148 (emphasis added). In other words, a competitor using unbundled network elements configures and operates its own network —it merely uses some parts obtained from the incumbent.

Not every network facility must be unbundled and provided to competing carriers under section 251(c)(3). The Act limits the scope of the unbundling requirement by charging the FCC with the task of "determining what network elements should be made available" under section 251(c)(3). 47 U.S.C. § 251(d)(2). Congress prescribed specific criteria for the FCC to use in making this determination: The FCC must consider at a minimum whether lack of access to the element in question would "impair the ability" of a competitor to provide telephone service or, in the case of a network element that is "proprietary in nature," whether access is "necessary" for the competitor to provide service. 47 U.S.C. §§ 251(d)(2)(A), (B). Thus, an incumbent LEC's unbundling duty is limited to those network facilities that, according to the FCC, need to be available *from the incumbent* to enable the requesting carrier to compete effectively.

In addition, the Act defines a network element, not broadly as *any asset* owned by an incumbent LEC, but more narrowly as a "facility or equipment used in the provision of a telecommunications service" or the "features, functions, and capabilities" provided by such a phys-

ical component of the network. 47 U.S.C. § 153(29). Thus, network elements are individual, physical *pieces* of the network that the incumbent LEC uses to route and deliver calls. A carrier using unbundled elements purchases these pieces individually and combines them with its own facilities to create its own network. *See* 47 U.S.C. § 251(c)(3) ("An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.").

To ensure that an incumbent LEC's essential facilities would be available to new entrants on economically reasonable terms, Congress made network elements subject to the same cost-based pricing standard as interconnection: Prices for unbundled elements must be based on the cost to the incumbent LEC of providing them, must be nondiscriminatory, and may include a reasonable profit for the incumbent. 47 U.S.C. § 252(d)(1). The Act expressly requires that such cost-based prices be determined "without reference" to state ratemaking proceedings. 47 U.S.C. § 252(d)(1)(A)(i). The practical result has been that prices for unbundled elements, unlike state-mandated prices for complete services, have not reflected cross-subsidies designed to promote universal service.

b. The Resale Provisions of Section 251(c)(4). To enable a new local carrier to enter the market on a virtually immediate basis, the Act also provides carriers with a distinct entry strategy that permits them to begin competing without deploying *any* physical facilities of their own or taking any responsibility for configuring a network. Section 251(c)(4) allows a carrier to buy complete local exchange telecommunications services from an incumbent LEC at wholesale prices and then resell those services to customers in competition with the incumbent.

This resale option provides a quick and easy initial gambit for carriers seeking to enter the local telephone market. However, the scope of a reseller's competitive

activity is quite narrow. Since a carrier competing through resale buys entire finished services from the incumbent, *see* 47 U.S.C. § 251(c)(4)(A), its role is basically limited to marketing, billing, and collection. The work of actually carrying the customer's calls, as well as designing, investing in, and maintaining the network that will carry the calls, is handled exclusively by the incumbent LEC. In this regard, section 251(c)(4) provides a very different market entry strategy from section 251(c)(3).

Congress also subjected resale to an entirely different pricing standard than unbundled network elements—a "wholesale" standard that starts with the retail price and subtracts the marketing costs avoided by the incumbent LEC in selling at wholesale, thus maintaining intact any universal service cross-subsidies. *See* 47 U.S.C. § 252 (d)(3). By basing wholesale prices on retail prices, the Act ensures that the wholesale price for a service will reflect the same implicit contribution to support universal service (or receipt of such support) as the retail price for the service.[6] For example, if a state has set the retail price of a particular service two dollars above cost (including a reasonable profit) to help subsidize rates for other services, the wholesale price for that service will include the same two-dollar subsidy component. *See* H.R. Rep. No. 104-204, at 72 (1995) ("[I]n determining the resale rate, it is the Committee's intent that there be a recognition of pricing structures for telephone exchange service in the State. . . . The rate should reflect whether, and to what extent, the local dialtone service is subsidized by other services.").

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[6] The subsidy component is "implicit" because state regulators generally do not specify the precise amount by which particular services cross-subsidize or receive cross-subsidies from other services.

2. *Implementation through Negotiations and State Arbitration*

Consistent with its view that relations between market participants should be governed as far as possible by market forces rather than regulatory mandates, *see, e.g.*, Conference Report at 113 (describing the Act as creating a "de-regulatory national policy framework"), Congress created a system in which private negotiations between incumbent LECs and their competitors are the preferred method for implementing the Act's local competition provisions. Section 251(c)(1) imposes on incumbent LECs and competing carriers "[t]he duty to negotiate in good faith in accordance with section 252 the particular terms and conditions of agreements to fulfill the duties" described in section 251. 47 U.S.C. § 251(c)(1). Therefore, where a carrier wants to purchase interconnection, unbundled elements, or wholesale services for resale from an incumbent LEC, the first step is to negotiate a "binding agreement" with the incumbent for the purchase. 47 U.S.C. § 252(a)(1). Congress expressly directed that this voluntary negotiation process take precedence over regulatory mandates: Section 252(a)(1) provides that an incumbent LEC may negotiate an agreement with a competing carrier "without regard" to any of the pricing, technical, and quality standards set out in the Act. *Id.* The backstop to these private negotiations is the possibility of action by state public utility commissions. Either party to a negotiation may ask the relevant state commission to mediate or arbitrate unresolved issues. *Id.* §§ 252(a)(2), (b)(1).

3. *Preservation and Reform of Universal Service*

While the Act embraces competition and market forces, it also makes clear that support for universal service must not be impaired. The Act requires that support continue to be provided at levels that are "sufficient" to "preserve and advance" universal service. 47 U.S.C. §§ 254(b)(5), (d), (e). Since full-fledged competition will make implicit

cross-subsidies through service prices unsustainable in the long run, the Act requires the FCC to establish new mechanisms to support universal service that are "explicit" and "nondiscriminatory." 47 U.S.C. §§ 254(b)(4), (e), (f). The FCC must meet specific deadlines in carrying out its responsibilities for universal service reform, but state action to reform local rate structures is not subject to any timetable. *See* 47 U.S.C. §§ 254(a), (f).

C. The FCC's First Report and Order

On August 8, 1996, the FCC released its First Report and Order purporting to implement the Act's local competition provisions. The Order adopted rules concerning the scope of incumbent LECs' unbundled access obligations and a "pick-and-choose" rule giving competing carriers a trump card in their negotiations and agreements with incumbent LECs. As discussed in other briefs in this case, the Order also displaced state authority over local prices for interconnection and unbundled elements with a complex and sweeping set of federal pricing rules.

1. *The FCC's Unbundled Access Rules*

The Order established a series of rules specifying the FCC's interpretation of an incumbent LEC's unbundled access obligations under section 251(c)(3) of the Act. The rules required the unbundling of practically every aspect of an incumbent's business. Their cumulative effect was to enable an incumbent LEC's competitors to obtain complete, end-to-end service supplied entirely by the incumbent at the cost-based prices reserved for network elements.

First, the FCC ruled that, in carrying out its responsibility under section 251(d)(2) to consider whether lack of access to a particular unbundled element would "impair" the ability of a competitor to offer service or whether access to such an element is "necessary," the agency will not even consider the availability of substitutes from

sources other than the incumbent LEC. *See* Joint Appendix ("J.A.") 51-52, 54-55 (Order ¶¶ 283, 287). The FCC stated that the availability of elements from other sources should be ignored "because, in theory, any new entrant could provide all of the elements in the incumbents' networks." *Id.* at 54-55 (Order ¶ 287). Apparently rejecting Congress' determination that facilities-based competition is possible and desirable, the FCC also asserted that limiting the scope of unbundling to elements not readily available from other sources would require competing carriers to "duplicate unnecessarily" parts of the incumbent's network and thus "generate delay and higher costs for new entrants." *Id.* at 51-52 (Order ¶ 283); *see also id.* at 54-55 (Order ¶ 287). The agency therefore extended the unbundling obligations to "*all* network elements [of an incumbent LEC] for which it is *technically feasible* to provide access," including elements that are readily available from other sources at reasonable prices. *Id.* at 49, 53-54 (Order ¶¶ 278, 286) (emphasis added). In short, the FCC held that the "impair" and "necessary" standards are satisfied by virtually *any* potentially useful incumbent LEC facility, regardless of how commonplace or easy to duplicate. It declined to require any real showing of need. *See id.* at 53-54 (Order ¶ 286) ("We conclude that the statute does not require us to interpret the 'impairment' standard in a way that would significantly diminish the obligation imposed by section 251(c)(3).").

The FCC further interpreted the term "network element" to include items that are neither discrete physical parts of the network nor functions of such discrete physical parts. The FCC determined that services provided via personnel and equipment entirely separate from the telephone network itself could nonetheless be network elements. In particular, the Order classified as network elements such nonnetwork items as back-office support systems (for example, systems used to take orders from retail customers) and operator services using human operators.

Id. at 116-17, 126-27 (Order ¶¶ 516, 536). The FCC further ruled that services such as caller I.D., call forwarding, and call waiting are included in the "local switching element" despite the fact that they constitute complete retail telecommunications services available to end user customers and to the incumbent LEC's competitors under the Act's resale provisions. *Id.* at 87-89 & n.917 (Order ¶¶ 413-14 & n.917).

The FCC not only made virtually every aspect of an incumbent LEC's business available to new entrants under section 251(c)(3), it also ruled that a new entrant may obtain from the incumbent LEC the *full set* of network elements necessary to provide a finished service. Pet. App. 242a-49a (¶¶ 328-41). The agency further mandated that the incumbent LEC provide the requested elements on a *combined* basis: The FCC's rules both required an incumbent LEC to combine elements on its competitors' behalf and forbade an incumbent to separate any elements that it has already combined in its own network. 47 C.F.R. §§ 51.315(b)-(f).[7] As a result, an incumbent's competitors could obtain a fully assembled combination of all the elements needed to provide service, the so-called "UNE platform." Access to this "platform" enables a competitor effectively to buy and resell the incumbent's finished local exchange services, without making any investment in network facilities of its own and without undertaking any of the tasks involved in configuring and operating a network. Such a competitor need not even determine which particular facilities will be used to carry its customers' traffic; it can force the incumbent to do that for it as well.

[7] The FCC's rules further obligated an incumbent LEC to combine network elements at the direction of a competitor to create even services not offered by the incumbent itself. *See* 47 C.F.R. § 51.315(c) (requiring an incumbent LEC to "perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LEC's network").

In short, these rules together allowed a competitor of an incumbent LEC to purchase as unbundled network elements virtually any functions the incumbent performs as part of its business and order the incumbent to combine those elements and use them to provide service on behalf of the competitor. The competitor effectively could obtain, at the cost-based prices reserved for network elements, *any* service that the incumbent provides or is capable of providing, for the competitor to resell to customers under its own brand name—all without making the slightest investment in facilities or systems of its own.

Moreover, the FCC ordered that, except for a limited, temporary, and now-expired exemption, the cost-based prices for unbundled network elements may not include any part of the costs of supporting universal service (that is, the costs of subsidizing residential and rural service). *See* J.A. 153, 155-59 (Order ¶¶ 712, 715-20).[8] As a result, a competitor taking advantage of the FCC's rules to offer service entirely through unbundled network elements could avoid contributing to the universal service subsidies built into state-mandated rate systems. For services priced above cost—for example, business services —the carrier naturally would opt to buy the service as a collection of combined elements, and thus pay a cost-based rate, as opposed to buying it under the resale provision at the higher wholesale rate that includes support for universal service subsidies. In this way, the carrier could engage in regulatory arbitrage by taking advan-

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[8] More generally, the FCC distorted the statute's requirement of cost-based rates by, among other things, ordering that rates be based not on the *actual* cost of providing service, but rather on the cost of providing service using a hypothetical, ideally efficient network. *See* 47 C.F.R. § 51.505(b)(1) (prices must be "based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration"). The substantive validity of this and other pricing rules is not before the Court because the court of appeals vacated them on jurisdictional grounds.

tage of the difference between state-mandated retail prices and unbundled element prices.

In addition to giving competitors cost-based, subsidy-free access to any combination of an incumbent LEC's existing business assets, the FCC required the incumbent LEC to make available network elements "superior in quality to that which the incumbent LEC provides to itself." 47 C.F.R. § 51.311(c). As a result, a competitor wanting something new, instead of investing itself in an improved facility, could require the incumbent LEC to make the necessary investment on its behalf.

The cumulative effect of the FCC's unbundling rules was to broaden greatly the opportunity and incentive of new competitors to rely on the incumbent LEC's network instead of investing in facilities of their own. Any new investment by the incumbent, no matter how easily available from other sources, had to be made available at cost-based rates and combined by the incumbent LEC at the behest of the competitor. In the FCC's view, this dramatic action was necessary to permit all competitors to share whatever competitive advantage the incumbent LEC might have—thus entirely depriving the incumbent of any such advantage irrespective of whether access to the facilities involved is truly necessary for the advancement of competition.

2. *The FCC's "Pick-and-Choose" Rule*

Section 252(i) of the Act requires an incumbent LEC to offer a competing carrier any "interconnection, service, or network element" that the incumbent has provided to another carrier under a prior interconnection agreement, on the "same terms and conditions" as in the prior agreement. 47 U.S.C. § 252(i). The FCC invoked this nondiscrimination requirement as the basis for a quite different rule that permits a competitor to pick and choose isolated provisions from previous interconnection agree-

ments and to take advantage of those provisions without any obligation to accept terms and conditions that may have been part of the quid pro quo for those provisions in the original agreements. Pet. App. 261a-64a (Order ¶¶ 1310, 1314-15). The FCC's rule further creates a unilateral right of competing carriers to change the terms of previously concluded, purportedly "binding" interconnection agreements. Specifically, the FCC decreed that a competing carrier may at any time reopen a final, validly negotiated or arbitrated interconnection agreement to incorporate any isolated term or condition found in a subsequent interconnection agreement between the incumbent LEC and another carrier. *Id.* at 264a-65a (Order ¶ 1316).

The FCC dismissed the concern that this "pick-and-choose" rule would undermine the Act's regime by rendering it irrational for incumbent LECs to make concessions in negotiated agreements. The FCC's response focused solely on whether the rule would benefit the incumbent LEC's competitors: "[W]e observe that new entrants, who stand to lose the most if negotiations are delayed, generally do not argue that concern over slow negotiations would outweigh the benefits they would derive from being able to choose among terms of publicly filed agreements." *Id.* at 263a (Order ¶ 1313).

3. *The FCC's Assertion of Jurisdiction over Pricing*

Despite Congress' decision to implement the requirements of section 251 primarily through private negotiations backed up by the possibility of state-level mediation or arbitration, the FCC promulgated a sweeping set of detailed nationwide pricing rules. The lawfulness of the FCC's assertion of jurisdiction over the pricing of interconnection and unbundled elements is a major focus of other briefs in this case, and this brief does not discuss it.

D. The Appeal to the Eighth Circuit

Incumbent LECs and state utility commissions sought judicial review of the FCC's First Report and Order, and the cases were consolidated in the U.S. Court of Appeals for the Eighth Circuit. The appeals focused on the FCC's rules concerning the scope of an incumbent LEC's duty to provide unbundled access to network elements; the "pick-and-choose" rule; and the FCC's assertion of jurisdiction over pricing. Many of the petitioners also requested a stay of the Order, in whole or in part, pending the outcome of the appeal. On October 15, 1996, the court of appeals stayed the FCC's pricing and "pick-and-choose" rules. J.A. 224-42. This Court declined to vacate the stay. *FCC v. Iowa Utils. Bd.*, 117 S. Ct. 429 (1996).

After consideration on the merits, the court of appeals issued a decision on July 18, 1997 invalidating a number of the pertinent FCC rules, but upholding others. Pet. App. 1a-67a. It upheld the FCC's conclusion that the "impair" and "necessary" standards in section 251(d)(2) do not require the agency to be selective in determining what elements must be unbundled. In particular, the court held that those standards "do not require an inquiry into whether a competing carrier could obtain the element from another source." *Id.* at 47a-48a. The court reasoned that requiring such an inquiry would severely narrow the scope of an incumbent's unbundling obligation because "many network elements could theoretically be duplicated eventually." *Id.* at 48a. The court also upheld the FCC's determination that nonnetwork items such as back-office support systems and end-user services such as caller I.D. can qualify as "network elements." *Id.* at 41a-45a.

However, the court of appeals rejected the FCC's extension of the unbundled access obligation to all elements for which unbundling is "technically feasible." The court held that section 251(c)(3) requires unbundled access

"at any technically feasible point" in order to establish *where* access may occur, not *which* elements must be unbundled. *Id.* at 45a. The court likewise rejected the FCC's rules requiring an incumbent LEC to provide unbundled elements and interconnection of superior quality to that which it provides to itself. *Id.* at 50a-52a.

The court also vacated the rules requiring incumbent LECs to combine elements on behalf of their competitors. The court explained that, "[w]hile the Act requires incumbent LECs to provide elements in a manner that enables the competing carriers to combine them, unlike the Commission, we do not believe that this language can be read to levy a duty on the incumbent LECs to do the actual combining of elements." *Id.* at 53a. "[T]he plain meaning of the Act," the court continued, "indicates that the requesting carriers will combine the unbundled elements themselves; the Act does not require the incumbent LECs to do *all* of the work." *Id.* However, the court did not address section 51.315(b) of the FCC's rules, the provision that prohibited incumbent LECs from separating elements that were already combined in their networks.

The court upheld the FCC's determination that carriers with no facilities of their own may provide local service entirely through unbundled elements, but also accepted the premise, critical for the preservation of universal service, that Congress did not intend unbundled access and resale to be interchangeable. The court upheld the rule precisely because it believed that "unbundled access has several disadvantages that preserve resale as a meaningful alternative." *Id.* at 56a. Specifically, the court stated that, in light of its ruling on the combination of elements, a competitor providing service entirely through unbundled elements is different from a reseller because it "expend[s] valuable time and resources recombining unbundled network elements." *Id.* at 56a-57a. The court also noted that the competitor using network elements bears "greater risks" in attempting to "match its supply with its demand."

Id. at 56a. In other words, such a competitor is subject to the ordinary expenses and business risks associated with configuring and operating a local telephone network.

The court reaffirmed its rejection in its stay decision of the FCC's "pick-and-choose" and pricing rules. The court explained that the "pick-and-choose" rule "would thwart the negotiation process" required by the Act, because, "[d]uring a negotiation, an incumbent LEC would be very reluctant to make a concession on one term in exchange for a benefit on another term when faced with the prospect that a subsequent competing carrier will be able to receive the concession without having to grant the incumbent the corresponding benefit." *Id.* at 26a. The court also observed that the "pick-and-choose" rule conflicts with the Act's requirement that negotiated agreements be binding, "because, according to the FCC, an entrant who is an original party to an agreement may unilaterally incorporate more advantageous provisions contained in subsequent agreements negotiated by other carriers." *Id.* With respect to the FCC's pricing rules, the court held that "the FCC exceeded its jurisdiction in promulgating the pricing rules regarding local telephone service." *Id.* at 8a.

Following the court of appeals' decision, a number of incumbent LECs filed petitions for rehearing urging the court to vacate 47 C.F.R. § 51.315(b), the rule that forbade incumbents from separating elements that are currently combined in their networks. The petitions noted that carriers such as AT&T and MCI had seized on the court's silence about rule 51.315(b) to argue to state commissions that those carriers were still entitled to get the fully combined "platform" of network elements where those elements are already combined in the incumbent's network.[9] On October 14, 1997, the court of appeals

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[9] *See* Petition for Rehearing of GTE entities, SBC Communications, Inc., BellSouth Corporation, and U S WEST, Inc., *Iowa*

granted the rehearing petitions and amended its opinion to strike down rule 51.315(b) as contrary to the Act. Reinforcing its earlier decision regarding network element combinations, the court explained that "Section 251(c)(3) requires an incumbent LEC to provide access to the elements of its network only on an unbundled (as opposed to a combined) basis," and "does not permit a new entrant to purchase the incumbent LEC's assembled platform(s) of combined network elements (or any lesser existing combination of two or more elements)." Pet. App. 71a. The court stressed that "[t]o permit such an acquisition of already combined elements at cost based rates for unbundled access would obliterate the careful distinction Congress has drawn in subsections 251(c)(3) and (4)" between access to unbundled elements and the purchase of services for resale. *Id.*

E. Certiorari Proceedings

The FCC, MCI, AT&T, and other parties filed petitions for certiorari seeking review of the court of appeals' decision to vacate the FCC's pricing rules, the "pick-and-choose" rule, and rule 51.315(b). Incumbent LECs submitted conditional cross-petitions arguing that, if the Court decided to review the court of appeals' rejection of rule 51.315(b), it should consider the lower court's holdings on the other unbundled access issues as well. On January 26, 1998 the Court granted certiorari on all of the issues raised in the petitions and cross-petitions.

SUMMARY OF ARGUMENT

Through the unbundling and resale provisions in sections 251 and 252 of the Act, Congress devised a structure that would promote a number of different goals—increased competition, greater investment and innovation, the preser-

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Utilities Board v. FCC (No. 96-3321 and consolidated cases, 8th Cir.) at 2.

vation of universal service, and ultimately enhanced consumer welfare. Congress sought to foster an environment in which new entrants have the incentive to build their own physical facilities to compete with the incumbents' networks because it understood that such independent facilities are vital to creating a vigorous competitive market in local telephony. At the same time, Congress recognized that not every potential competitor could immediately construct a complete alternative network. To encourage the eventual development of facilities-based competition, Congress granted newcomers the option to buy some unbundled physical inputs from the incumbents to combine with their own incomplete sets of facilities until they were able to assemble complete networks capable of providing finished services. Congress also permitted competitors that wished to enter without investing in any facilities to buy and resell incumbents' own finished services.

In structuring these alternative avenues of entry, Congress struck a balance designed to give new entrants access to incumbents' networks and services where necessary to enable them to begin to compete, while preserving newcomers' incentives to build their own facilities. That is, Congress sought to ensure that the use of incumbents' unbundled facilities would not become so economically attractive as to stifle any incentive for new entrants to engage in facilities-based competition. In accordance with this goal, the Act provides that incumbents can be required to unbundle only in cases where new entrants truly need such elements to enter the marketplace, much as antitrust law requires monopolists to provide access only to those facilities that are *essential* to competitors. This limitation is reinforced by the statute's definition of "network elements," which includes only those parts of an incumbent's network that might not be reasonably available to new entrants in the competitive marketplace —the physical elements and their associated features and functions.

Consistent with this concept of unbundling, the statute also requires that incumbents provide the discrete, physical facilities to new entrants "in a manner that allows requesting carriers to combine such elements" to provide service. 47 U.S.C. § 251(c)(3). The statute thus makes clear that the purchaser of elements is expected to design and create a network of its own by combining the unbundled, "essential" elements it obtains from an incumbent with its own facilities. For a new competitor that wants to rely solely on an incumbent's network and have no facilities of its own, the statute provides the alternative option of purchasing and reselling an incumbent's retail *services.* However, a competitor that engages in resale must buy services from the incumbent at prices based on retail rates, rather than the cost-based prices for unbundled network elements. By basing resale prices on retail rates, Congress ensured that incumbents would not be deprived of the universal service subsidies implicit in their rates.

In its Order, the FCC destroyed the statute's careful balance by focusing on helping new competitors without regard to the statutory language or to the overall effects of its actions on Congress' goals. Indeed, the FCC's decisions reflect a rejection of Congress' intent to promote facilities-based competition in favor of transforming the incumbent's network into a wholesale platform for competitors, at the expense of true competition, innovation and investment, universal service, and ultimately the welfare of consumers. The FCC unlawfully expanded the Act's unbundling duty in four distinct but related ways:

First, the FCC effectively nullified Congress' directive that the agency consider "at a minimum" whether denial of access to network elements would "impair" service or, in the case of proprietary elements, whether access was in fact "necessary." In particular, the FCC refused even to consider whether an entrant can procure a particular element from a source other than an incumbent, effectively guaranteeing that an incumbent must provide every "net-

work element" to its competitors, rather than merely those bottleneck local exchange facilities a competitor needs but cannot reasonably duplicate. *Second*, the FCC compounded this error by redefining "network element" to include not only physical facilities and their accompanying features and functions, but virtually every part of an incumbent's business, from its personnel to billing software, even though such assets are not part of an incumbent's network.

Through these two errors, the FCC transformed the unbundling requirement from a limited right to obtain "essential facilities" into a right to obtain virtually every part of the incumbent's business as a network element at a price dictated by the FCC. And, far from backtracking from this transformation, the FCC embraced it in two additional parts of its Order. In its *third* unlawful expansion of the unbundling obligation, the FCC determined that a competitor could buy *all* the network elements needed to provide service under the pretense of buying them as individual pieces, so that the competitor could rely exclusively on unbundled network elements from an incumbent to provide finished services without having any facilities of its own. *Finally*, the FCC completed its work by deciding that competitors were entitled to acquire all of these pieces from the incumbent in precombined form as a fully assembled network.

In addition to defeating Congress' purposes in the Act's unbundling and resale provisions, the FCC further undermined the statutory structure by taking the straightforward nondiscrimination requirement in section 252(i) of the Act—under which an entrant can take for itself a prior interconnection agreement if it is willing to accept all the terms of that agreement—and reconstructing it as an extraordinary right of an entrant to "pick and choose" any individual term from the incumbent's past and future agreements with other carriers, even *after* the entrant has signed an agreement with the incumbent. In other words,

the entrant may at any time have the full commercial benefit of any isolated provision in any other agreement, entirely uncoupled from the balance of that agreement. In requiring this, the FCC made a mockery of the commercial negotiations that are central to the implementation scheme of section 252 and contradicted the statute's directive that interconnection agreements are to be "binding."

Each of these decisions by the FCC is contrary to the language, structure, and purposes of the 1996 Act. More significantly, the combined effect of these decisions is to undermine entirely the balanced regime Congress created. The agency's rules defeat the goal of promoting facilities-based competition by collapsing the statutory distinction between unbundled network elements and resale and creating an economically irrational model in which competitors have no reason to invest in their own facilities, incumbents have no incentive to innovate, and traditional universal service support is undermined.

ARGUMENT [10]

I. THE FCC'S UNBUNDLING RULES COLLAPSE THE CAREFUL STRUCTURE OF THE ACT AND DEFEAT THE GOALS CONGRESS SOUGHT TO ACHIEVE.

In the Telecommunications Act of 1996, Congress did not simply declare that local communications markets should be opened to competition and leave to the FCC the question of how best to reach that goal. To the contrary, Congress mapped out in detail the ways in which new entrants could use incumbents' facilities and services in entering local exchange markets, a map that it expected

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[10] U S WEST incorporates by reference the argument made in the brief for Bell Atlantic Corp., BellSouth Corp., and SBC Communications, Inc. concerning the court of appeals' ruling that the FCC exceeded its jurisdiction with respect to pricing. *See* Opening Brief of Respondents/Cross-Petitioners Bell Atlantic Corp., BellSouth Corp., and SBC Communications, Inc. (May 18, 1998).

the FCC to follow. This case is about the FCC's refusal to heed Congress' will.

Despite the FCC's attempts to cloak itself in the protective mantle of *Chevron,* its unbundling rules are contrary to the plain meaning of the 1996 Act, as evident from its language, structure, and legislative history. *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 & n.9 (1984) (if by "employing traditional tools of statutory construction" the Court finds Congress' intent to be clear, then "that is the end of the matter"). The FCC's attempt to have this Court review each of its individual decisions in isolation and to claim deference as to each of these discrete issues ignores this Court's oft-repeated admonition that, "in ascertaining the plain meaning of the statute, the court must look to the particular statutory language at issue, *as well as the language and design of the statute as a whole.*" *Sullivan v. Everhart,* 494 U.S. 83, 89 (1990) (emphasis added).

While each individual deviation from the Act is important by itself, the cumulative effect of the FCC's errors is utterly inconsistent with the design of the 1996 Act as a whole. The FCC disregarded Congress' intention that incumbents be required to provide only those network elements that their competitors truly need, extended the definition of network element to encompass virtually every part of an incumbent's business, and permitted entrants to procure all the elements needed to provide a service on a precombined basis. By these decisions, the FCC abrogated Congress' careful distinction between unbundled network elements and resale and undermined the development of facilities-based competition, discouraged innovation, and put at risk universal service support. The court below, while failing to correct all of these errors, mitigated their cumulative effect by vacating the FCC's rules requiring incumbents to provide network elements as precombined, assembled network platforms. Even so, the court below

did not go far enough. The FCC's " 'construction[] of [the] statute . . . [is] inconsistent with the statutory mandate [and] frustrate[s] the policy that Congress sought to implement' " and therefore must be rejected. *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 143 (1984) (quoting *FEC v. Democratic Senatorial Campaign Comm.*, 454 U.S. 27, 32 (1981)).

A. The FCC Unlawfully Nullified the Act's Standards for What Network Elements Must Be Unbundled.

The Act draws clear limits around what "network elements" must be unbundled. Section 251(d)(2) charges the FCC with the task of "determining what network elements should be made available" under section 251 (c)(3). 47 U.S.C. § 251(d)(2). Congress prescribed that the FCC "*shall* consider, at a minimum," whether the failure to provide access to particular network elements would "impair" the ability of the requesting carriers to provide service and whether access to proprietary network elements is "necessary." 47 U.S.C. § 251(d)(2) (emphasis added). These statutory commands reflect Congress' recognition that access to an unbundled element of the incumbent's network is economically justified only when a new entrant genuinely needs the element in order to compete and the element is not readily available in the marketplace. As AT&T explained in its opening brief, the goal of these provisions was to "allow new entrants to obtain *essential facilities* that a LEC controls." AT&T Br. at 2 (emphasis added). And determining whether an incumbent's facility is essential or needed by a competitor requires examining whether and how easily it can duplicate the equivalent facility itself.

By mandating an evaluation of need—under the "impair" and "necessary" standards—Congress sought to encourage new entrants to rely on nonincumbent facilities where possible, in order to promote facilities-based competition and encourage innovation. *See, e.g.*, H.R. Conf.

Rep. No. 104-458, at 1 (1996) (passage of the Act would "accelerate rapidly private sector deployment of advanced telecommunications and information technologies") ("Conference Report"); *In the Matter of Amendment of the Commission's Rules to Establish Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services,* Notice of Proposed Rulemaking, Order on Remand, and Waiver Order, 11 F.C.C.R. 16639, 16678-79 ¶ 80 (1996) ("The interconnection provisions of the Act, Section[s] 251 and 252, are designed to promote facilities-based local exchange competition.").[11]

After all, it is precisely where the new entrant can provide or acquire its own competitive facilities that the potential to increase the choices available to consumers is greatest: "[C]ompetition [is] increased by encouraging [firms] to [develop rival facilities], rather than taking the easier and less competitive course of obtaining access to another's facilities." 3A Philip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 773b1 (1996). A competitor that depends on an incumbent's network cannot compete on the basis of operational efficiency or upgrade the network, and it has limited ability to create new services. A facilities-based competitor, on the other hand, is a rival to the incumbent at *every* level of operation and has incentives to invest in the creation of innovative technologies and services and to achieve operational economies.

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[11] *See also Communications Law Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce,* 104th Cong. 9 (1995) (the Act "rightly stresses a need for facilities-based competitors to lead the way in providing a true alternative to today's monopoly in the local exchange service. In fact, it is no exaggeration to say that the entire bill is premised on the existence of robust facilities-based competitors") (statement of Rep. Schaefer); 141 Cong. Rec. H8465 (Aug. 4, 1995) (the Act is intended to "give[] new entrants the incentive to build their own local facilities-based networks, rather than simply repackaging and reselling the local services of the local telephone company") (statement of Rep. Goodlatte).

In its zeal to aid competitors without regard to the effects on facilities-based competition, the FCC adopted rules that unlawfully thwarted Congress' intent. *See generally* Hon. Stephen G. Breyer, "Antitrust, Deregulation, and the Newly Liberated Marketplace," 75 Calif. L. Rev. 1005, 1018 (1987) ("A . . . special policy risk of deregulation is that government policymakers will protect [new] competitors instead of protecting competition."). As the court below explained, the FCC determined that the "impair" and "necessary" standards did "not require an evaluation of whether a requesting carrier could obtain the desired elements from an alternative source," but instead authorized the FCC to consider solely the other elements that the new entrant could obtain *from the incumbent LEC's own network.* Pet. App. 47a. Rather than constituting a meaningful evaluation of whether the facilities in question are truly needed by a competitor, the FCC's reading of the Act renders irrelevant even readily available alternatives outside the incumbent LEC's network that could enable the newcomer to provide service equal in quality and cost to what is achievable using the incumbent's facilities. Thus, the FCC guaranteed each competitor the ability to acquire from incumbents every network element it desires to provide service no matter how easily the competitor could obtain a substitute elsewhere.

That approach defies the plain meaning of the Act. Failure to obtain an element from an incumbent cannot "impair" a new entrant's ability to provide service, and access to a proprietary element from an incumbent cannot be "necessary," if an equivalent element is readily available from a source other than the incumbent. When Congress directed the FCC to consider the "impair" and "necessary" standards in deciding whether to require unbundling of a particular element, it obviously intended that there be some showing of need before the incumbent could be required to unbundle any particular element, not that a competitor could commandeer any of an incumbent's facili-

ties whenever convenient. Even the FCC concedes that the unbundling provisions authorize competitors to obtain access to "elements they need (and not elements they do not need)." FCC Br. at 5. Whatever the degree of need that must be shown, the competitor's need to obtain the element from the incumbent cannot be evaluated without at least considering what the competitor can procure elsewhere.[12]

The FCC's primary justification for ignoring all sources outside the incumbent's network was its assertion that any consideration of nonincumbent sources might require new entrants to "duplicate unnecessarily even a part of the incumbent's network." J.A. 51-52, 54-55 (Order ¶¶ 283, 287). But this justification merely illustrates the FCC's transformation of Congress' objective—facilities-based competition—into a pejorative. Facilities-based competition by definition involves duplication of facilities. The FCC disagrees with this goal, apparently preferring to perpetuate markets in which incumbent LECs own the only facilities used for telecommunications services and are forced to share those facilities with competitors under regulatory supervision. But the FCC is bound by Congress' contrary choice: "[R]apid[] private sector deployment of advanced telecommunications and information technologies," Conference Report at 1, requires building new facilities.

The FCC also sought to rationalize its decision to disregard what is available from sources other than the incumbent on the theory that "ultimately" every facility can be replicated and thus consideration of outside sources

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[12] Indeed, by so severing the relationship between the incumbent's obligation to provide its facilities to a competitor and the competitor's true economic need for the facilities, the FCC threatens to run afoul of this Court's repeated statement that "one person's property may not be taken for the benefit of another private person without a justifying public purpose, even though compensation be paid." *Hawaii Housing Auth. v. Midkiff*, 467 U.S. 229, 240 (1984) (quoting *Thompson v. Consolidated Gas Corp.*, 300 U.S. 55, 80 (1937)).

would mean that none of the incumbent's facilities would be made available. J.A. 54-55 (Order ¶ 287). Or, as the court below put it, considering outside sources might limit the availability of unbundled network elements "because many network elements could theoretically be duplicated eventually." Pet. App. 48a. But the fact that availability is a matter of degree or that it may change over time merely means that the FCC must inquire into actual market conditions to determine where to draw a line as to the degree of availability that will warrant a finding of lack of "impairment" and that such a line might change over time. The FCC's reading of the statute simply bypasses these issues by making an alternative facility irrelevant even if it is readily available today at the same or lower price than the incumbent's.

The FCC's refusal even to consider the availability of facilities outside an incumbent's network is inconsistent with not only the terms of the statute but also basic economic principles. When the government "order[s] the [monopolist] to provide the facility and regulat[es] the price to competitive levels, then the [prospective entrant's] incentive to build an alternative facility is destroyed altogether. . . . [Loss of incentive to build] could be extremely serious . . . in the case where either the [entrant] or some other rival could enter the market by some alternative not requiring the sharing of the [monopolist's] facility." 3A Areeda & Hovenkamp, *supra*, ¶ 771b.

Not surprisingly then, in the closely analogous context of the "essential facilities" doctrine, under which monopolists are required to provide prospective competitors with access to their essential facilities to aid the development of competition, a facility must be turned over for use by competitors *only* if it is not "available from another source or capable of being duplicated by the [competitor] or others." *Id.* ¶ 773b.[13] The lower courts are unanimous in

[13] *See also* ABA Section of Antitrust Law, *Antitrust Law Developments* 280 (4th ed. 1997) ("It is insufficient, however, for a

holding that a prerequisite to requiring a monopolist to turn over an essential facility is "a competitor's inability practically or reasonably to duplicate" the facility. *MCI Communications Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1132-33 (7th Cir.), *cert. denied*, 464 U.S. 891 (1983).[14] The FCC's refusal even to consider whether or how easily an element could be obtained from a source other than the incumbent cannot be reconciled with the statutory language or these underlying principles.[15]

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plaintiff to allege that access to one facility is simply 'more economical' than other alternatives . . . ."); William Blumenthal, "Three Vexing Issues Under the Essential Facilities Doctrine: ATM Networks as Illustration," 58 Antitrust L.J. 855, 860 (1989) ("In light of the potentially perverse competitive incentives created by the opportunity for compulsory access, a plaintiff should not be granted access in an essential facilities case unless alternatives to the facility are extraordinarily difficult for anyone to put in place." (citations omitted)); Panel Discussion, "Exclusionary Conduct," 57 Antitrust L.J. 723, 742 (1989) ("There is a great danger in . . . the notion that it somehow is easy to let competitors have access without impairing the facility.") (comments by William Baxter).

[14] *See also Twin Labs. Inc. v. Weider Health & Fitness*, 900 F.2d 566, 568 (2d Cir. 1990); *Ideal Dairy Farms, Inc. v. John Labatt, Ltd.*, 90 F.3d 737, 748 (3d Cir. 1996); *Laurel Sand & Gravel, Inc. v. CSX Transp., Inc.*, 924 F.2d 539, 544 (4th Cir.), *cert. denied*, 502 U.S. 814 (1991); *City of Malden v. Union Elec. Co.*, 887 F.2d 157, 159 (8th Cir. 1989); *City of Anaheim v. Southern Calif. Edison Co.*, 955 F.2d 1373, 1380 (9th Cir. 1992); *McKenzie v. Mercy Hosp.*, 854 F.2d 365, 369 (10th Cir. 1988), *overruled on other grounds by SystemCare, Inc. v. Wang Labs. Corp.*, 117 F.3d 1137 (10th Cir. 1997).

[15] The FCC's seeming blindness to the relationship between network elements and the concept of "essential facilities" is particularly perplexing in light of its recognition elsewhere that Congress' focus in the 1996 Act was the control of essential facilities: "[T]he structural and nondiscrimination requirements [of section 272] taken together were intended by Congress to effectuate the goal of preventing anticompetitive abuses by BOCs that *control essential local facilities* and seek to enter competitive markets that require these facilities as an input." *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of*

The FCC's evisceration of the statutory "impair" and "necessary" standards also means that a new entrant's entitlement to particular network elements will not change as the marketplace evolves. Even if lack of access to a particular element will impair service (or the element is necessary) at one point in time, the availability of a new technology or another change in the marketplace may over time eliminate the need to acquire that element from the incumbent. For example, even if lack of access to the local loop would impair an entrant's ability to provide service today, that effect might disappear once cable television, wireless, or other technologies offer equivalent access to the home in the future.[16] Similarly, as a competitor establishes itself in the marketplace, it may capture a sufficient number of customers to generate the economies of scale that would allow it to build particular facilities that were not feasible for it to build on initial entry. *See* AT&T Br. at 14 (Congress intended unbundled elements to allow "new entrants to share in whatever economies of scale inhere in particular LEC facilities"). Such developments clearly would affect whether lack of access to the incumbent's facility would "impair" the newcomer's ability to compete under any common sense meaning of the term—yet under the FCC's construction of the Act such developments are to be ignored entirely.

The FCC's rule makes even less sense in the context of proprietary elements—those in which an incumbent holds an intellectual property interest. Congress required the FCC to apply the even stricter "necessary" standard to the unbundling of such elements, because it no doubt understood that an incumbent LEC will not invest in research and development if its innovations must automatically be turned over to rivals. *See, e.g., Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 480 (1974) (right of

1934, as Amended, Second Order on Reconsideration, 12 F.C.C.R. 8653, 8658 (1997) (emphasis added).

[16] *See, e.g., supra* note 5.

exclusivity provides "an incentive to inventors to risk the often enormous costs in terms of time, research, and development").[17] Nevertheless, the FCC decided that, where an incumbent invests in developing a new proprietary service or feature, the incumbent can be forced immediately to turn that service or feature over to its competitors at cost regardless of whether the competitors can obtain its equivalent elsewhere.

The only situation in which the FCC did not require an incumbent to turn over a proprietary element is if a nonproprietary element *in the incumbent's own network* can perform the same function equally well at the same or lower price. J.A. 51-52 (Order ¶ 283). Of course, the incumbent would have had no reason to develop the proprietary element in the first place if it already had other elements capable of performing the same function equally well. Congress wanted the Act to spur innovation, not retard it. However, the effect of the FCC's nullification of the necessary standard, as even the FCC admitted in its order, *id.* at 50-51 (Order ¶ 282), will be to reduce incumbents' incentives to innovate in direct contravention of Congress' intent.

B. The FCC Unlawfully Expanded the Act's Definition of "Network Element."

The FCC not only ignored the Act's express limitations on the availability of "network elements" to an incumbent's competitors. It compounded the anticompetitive effect of that decision by rejecting the statutory limitations in the definition of "network element" itself. The FCC expanded the definition to encompass not just certain physical elements of an incumbent's network, but essentially all of the incumbent's productive assets and services,

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[17] *See also* Hon. Stephen G. Breyer, "Antitrust, Deregulation, and the Newly Liberated Marketplace," 75 Calif. L. Rev. 1005, 1034 (1987) (because "requiring an inventor . . . to give his secrets away to his competitors discourages innovation," courts have required bottleneck facilities to be turned over to competitors only in rare instances).

even those involving ordinary business skills and personnel that a competitor readily could provide for itself or hire from others.

The Act defines "network element" as a "facility or equipment," together with "features, functions, and capabilities that are provided *by means of such facility or equipment*." 47 U.S.C. § 153(29) (emphasis added.) Thus, the concept of network elements under the Act is rooted in the discrete *physical* equipment that carriers use in providing local exchange service. Indeed, the very term "*network* element" reinforces this meaning. After all, an incumbent's "network" is made up of the wires and switches that carry telephone calls. Moreover, a facility can only be a "network element" if it is "used in the transmission, routing, or other provision of a telecommunications service." *Id.* Through its use of terms such as "transmission" and "routing," Congress made clear that "network elements" refer to those pieces of equipment that the carrier uses for call delivery.[18]

This straightforward definition of "network element" reinforces the effect of the "impair" and "necessary" limitations in section 251(d): to give new entrants access to those of the incumbent LECs' physical assets they need to provide telecommunications service but cannot reasonably duplicate (at least in short term). "Network element" does not encompass aspects of an incumbent's business that Congress had no reason to believe posed an entry barrier, such as backroom functions that any new competitor could reasonably perform for itself.

The FCC, however, construed "network element" so broadly that it effectively permits an incumbent's competitors to demand access on an unbundled basis to every part—both physical and nonphysical—of an incumbent's

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[18] Congress' use of the term "other provision" in the definition does not, under the principle of *ejusdem generis*, expand network elements to include nonphysical aspects of an incumbent's business. *See infra* at 40.

business. Under the FCC's Order, "network element" includes not just facilities and equipment that are used to deliver calls, but also systems and functions that have no role in transmitting or routing a call over the network. For example, the Order requires incumbent LECs to unbundle their "operational support systems." 47 C.F.R. § 51.319(f). These are computers and software used in an incumbent's customer service operations, not facilities or features that are used to route or transmit telephone calls. As their name suggests, they are *support* systems that an incumbent uses to run its business: to process orders, dispatch repairmen, and keep track of customer service requests. Requiring an incumbent to make these support functions available to competitors has nothing to do with unbundling the pieces of the network that the incumbent uses to deliver calls. And it has nothing to do with essential facilities—an incumbent's competitor can write or buy computer software as easily as the incumbent can. As a result, neither the plain terms nor the purposes of the definition of "network element" in the Act reach these software systems.

Indeed, the FCC does not even attempt to characterize these support systems as part of the equipment used to carry a call. To the contrary, the FCC declares that its objective in requiring incumbents to provide these support systems to their competitors is to ensure that the competitors will be able to perform business functions such as "pre-ordering, ordering, . . . and billing," J.A. 118 (Order ¶ 518), and "basic service functions [such] as scheduling customer appointments," *id.* at 118-20 (Order ¶ 519), in "substantially the same time and manner that an incumbent can for itself," *id.* at 118 (Order ¶ 518). But nothing in Congress' definition of network elements suggests that the incumbents' *business skills*—especially those that are not at all unique to the telecommunications business—must be turned over to competitors.

The FCC again disregarded the text of the statute in deciding that *services* offered by incumbent LECs, such as operator services and directory assistance, should be treated as "elements" subject to unbundling. *See id.* at 125-29 (Order ¶¶ 534-40). The FCC requires incumbents to make available to competitors the resources that incumbents use in providing these services, including their own staffs (that is, the operators themselves). *See* 47 C.F.R. § 51.5 (defining the operator services subject to unbundling as including "live assistance" to customers and "operator-assisted directory assistance"). But such services (not to mention people) are not even remotely within the definition of "network element." They are not "facilities" or "equipment" in the network. Nor are they "features, functions or capabilities . . . provided by means of" such facilities. And incumbents are not uniquely able to assemble staffs of operators. In fact, although the unbundling provision of the House bill originally applied to "*services,* elements, features, functions, and capabilities," the Conference Committee chose to delete the term "services" when it defined the scope of unbundling. *Compare* H.R. 1555, 104th Cong., 1st Sess. § 242(a)(2) (1995) (emphasis added) *with* 47 U.S.C. § 251(c)(3). The FCC has simply reversed Congress' decision.

The defect in the FCC's interpretation is further highlighted by its conclusion that "vertical services" such as call forwarding and call waiting are network elements. Vertical services are complete telecommunications services —not facilities—that incumbents sell at retail and thus must allow their competitors to buy at *wholesale rates* and then resell under section 251(c)(4). But the FCC's rules entitle competitors to obtain access to these same vertical services as network elements *at cost-based rates.* Thus, the FCC requires incumbents to make identical services available to competitors at two different prices. Doing so collapses the Act's two distinct means of accelerated entry for competitors—resale of service purchased

at wholesale discounts and access to unbundled network elements obtained at the incumbent's cost—through the sleight of hand of labeling vertical services as network elements. This result is particularly irrational because states typically set retail prices for vertical services above cost to support universal service, and allowing competitors to purchase vertical services at cost-based rates invites them to engage in regulatory arbitrage that undermines universal service. Congress intended no such result—it expressly deleted "services" from the definition of network element and defined an element as a "facility or equipment . . . *used* in the transmission, routing, or other provision of telecommunications service," not as such a service itself.

The FCC claimed its expansive view of network elements was justified in part by the definition's statement that elements include "*information* . . . used in the transmission, routing, or *other provision* of a telecommunications service." 47 U.S.C. § 153(29) (emphasis added). The FCC asserted that the term "other provision" expands the category of network elements beyond the physical delivery of telephone calls to virtually any information used for any purpose. J.A. 40 (Order ¶ 261). However, the general term "other provision" is limited by the more specific terms that precede it in the list. *See, e.g., Hughey v. United States*, 495 U.S. 411, 418 (1990); *United States v. Salen*, 235 U.S. 237, 244 (1914) (principle of *ejusdem generis*). Here, the other items in the list—"transmission" and "routing"—are functions of equipment used in the delivery of calls, and nothing in the statute suggests that the reference to "other provision" expands the definition beyond that type of function to encompass every aspect of operating a telephone company. To the contrary, that reference simply acknowledges that other technical functions of an incumbent's network, such as switching, also are involved in delivering a phone call. Nor can the reference to "telecommunications serv-

ice"—the "offering of telecommunications for a fee directly to the public," 47 U.S.C. § 153(46)—somehow unmoor the definition of "network element" from the core textual requirement that an element be a facility or equipment (or features and functions provided by means of such facility or equipment). The FCC's expansion of the category of network elements thus finds no support in the text of the Act.

The FCC's expansion of the definition to include support systems, retail services, and other parts of an incumbent's business beyond facilities used in call delivery is equally contrary to the purposes of the unbundling requirements. Most resources or assets of this kind, such as operator staffs to provide directory assistance, can readily be developed or acquired from sources other than an incumbent and are therefore beyond the scope of what a competitor would need from an incumbent in order to compete. By nevertheless requiring incumbents to provide these nonessential facilities and services, the FCC has stripped away any incentive new entrants would have to invest in the personnel and the development of skills required to run a local telephone business. Congress never envisioned such a result when it gave new entrants the option of using some of an incumbent's network elements as substitutes for the limited facilities entrants might not readily obtain elsewhere.

C. The FCC's Expansion of Incumbents' Unbundling Obligations Undermines the Structure of the Act by Permitting Competitors To Rely Exclusively on Unbundled Elements To Provide Service and Thereby Evade the Statutory Restrictions on Resale.

Under the FCC's decision, virtually every part of an incumbent's business is a "network element" and virtually every "network element" must be turned over to an incumbent's competitors. The FCC has taken the limited right that Congress granted competitors—to obtain from

incumbents physical facilities that are essential to compete but are not reasonably available from other sources—and has transformed that right into an almost unqualified entitlement to use every productive asset of an incumbent's business. As a result, as even the FCC explicitly acknowledged, Pet. App. 242a-44a (Order ¶¶ 328-32), an incumbent's competitors can rely exclusively on unbundled network elements from an incumbent to recreate and then resell finished retail services—and be supported by the incumbent's personnel and support functions.

This opportunity to engage in "sham unbundling" cannot be reconciled with the structure of the Act. The statute expressly creates two distinct entry options short of full facilities-based competition. A competitor that wants to utilize an incumbent's entire network without any facilities of its own can compete on the basis of marketing ability by buying the incumbent's finished services at wholesale rates and reselling them, as permitted under section 251(c)(4). Alternatively, section 251(c)(3) gives the competitor the option of obtaining at cost-based rates the individual "elements" that are reasonably available only from the incumbent's network and then combining those elements with the competitor's own facilities. Unlike a reseller, which obtains use of the same configuration of network facilities that the incumbent uses, a competitor using network elements leased from the incumbent must still design and configure its own network and identify which particular facilities will carry its customers' traffic.

What Congress did not intend is that the FCC would read the Act's provisions on unbundled elements so broadly that a competitor can procure as network elements from an incumbent *all* the facilities and other aspects of a local exchange business required to provide finished services, thereby totally duplicating local exchange service at a price different from that specified in

section 251(c)(4). Rather, Congress expected competitors to use at least some of their own facilities in constructing their networks or to pay the wholesale price for resale of services. Indeed, for that very reason, Congress directed incumbents to provide "physical collocation of equipment necessary for . . . access to unbundled network elements at the premises of the local exchange carrier" so that competitors would have places at which to connect their facilities with the network elements they purchase from incumbents. 47 U.S.C. § 251(c)(6). Congress recognized that a competitor might not be expected to have a full network in place when it begins offering local service and therefore that "[*s*]*ome* facilities and capabilities (e.g., central office switching) will likely *need* to be obtained from the incumbent local exchange carrier as network elements pursuant to new section 251." Conference Report at 148 (emphasis added). Unbundled access was intended to ensure "the interoperability of *both carriers' networks.*" S. Rep. No. 104-23, at 20 (1995) (emphasis added). By contrast, if a competitor wants to use an incumbent's entire network to offer service, the Act provides the option of resale, which permits "*non-facilities-based carriers* to have an opportunity to compete." H.R. Rep. No. 104-204, at 72 (1995) ("House Rep.") (emphasis added). The FCC's unbundling rules, however, allow a non-facilities-based carrier to use unbundled network elements as a substitute for resale at the price reserved for network elements.

The chance to exploit such sham unbundling directly contravenes Congress' goal of encouraging facilities-based competition. Because the FCC's rules give competitors the right to use, at cost-based prices, all of an incumbent's equipment, personnel, and other business assets necessary to run a local telephone business, competitors have little incentive to build their own facilities. It is far easier and less risky for competitors to force the incumbent to build and maintain its network for them, particularly when the opportunity for regulatory arbitrage allows the competitors

to siphon away the incumbent's profitable customers with no risk or investment. Indeed, the ability of new competitors to engage in regulatory arbitrage and gain a free-ride hurts not only incumbents, but also other new entrants that have chosen to engage in actual facilities-based competition.

The FCC's Order also frustrates the purposes of the Act by creating an opportunity for regulatory arbitrage, enabling new entrants to provide the same services as incumbents at lower prices that are the result not of any efficiencies but simply the evasion of universal service support obligations. Congress provided different pricing structures for the alternative competitive strategies of unbundled network elements and resale because of universal service concerns. While incumbents must offer unbundled network elements to rivals at cost—which the FCC has ruled cannot include universal service subsidies, *see* J.A. 153, 155-59 (Order ¶¶ 712, 715-20)—incumbents offer services for resale at prices discounted from retail rates, which do include such implicit subsidies. Congress legislated this difference in order to minimize arbitrage that would simply exploit these regulatory price differentials. *See* House Rep. at 72 ("The [resale] rate should reflect whether, and to what extent, the local dialtone service is subsidized by other services."). Congress was well aware that the traditional means of support for universal service was for states to require incumbent LECs to charge well above cost for some services (such as business services) in order to support below-cost prices for others (such as basic residential service to rural users). As Congress recognized, if resellers could purchase the former services at cost rather than at prices pegged to retail rates, they could lure away the incumbent's high-margin customers by charging less than the incumbent must charge to recoup the cost of serving subsidized customers.

The FCC's rules enable competitors to engage in precisely such arbitrage by allowing them to acquire at cost-

based prices all the network elements required to provide a service, thereby collapsing the distinction between unbundled network elements and resale. By obtaining an incumbent's finished service entirely through the incumbent's network elements at cost-based rates, competitors can undercut above-cost prices and deprive the incumbent of the subsidies that undergird universal service, while avoiding their own obligation to support universal service. At the same time, because competitors can obtain subsidized services at a discount from the below-cost rates incumbents must charge, competitors can resell them at comparably below-cost prices without needing to find subsidies to make up the difference between the actual cost and the price, as the incumbent would.

By creating a regime in which competitors will have every opportunity and incentive to undercut the above-cost prices on which incumbents must rely to support universal service, the FCC has assured through government regulation that incumbents will not, in the aggregate, be able to charge rates that recover their costs. Incumbents will continue to be forced by regulatory mandate to charge below-cost prices for some services. At the same time, because of the FCC's evisceration of the distinction between unbundling and resale, incumbents will not be compensated for providing these below-cost services—as they were previously—by having the ability to charge above-cost rates for other services. Such a reading of the Act threatens confiscation of incumbents' property and turns on its head the usual rule of statutory interpretation that statutes must be construed to minimize their potential constitutional infirmities. *See Edward J. DeBartolo Corp. v. Florida Gulf Coast Trades Council*, 485 U.S. 568, 575 (1988) ("[W]here an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress.").

MCI dismisses this opportunity for new entrants such as itself to engage in arbitrage because the existing implicit subsidies might someday end. MCI Br. at 25. But Congress clearly intended to prevent such arbitrage, no matter how long the opportunity for arbitrage might last —that is precisely why it provided two different pricing standards for unbundled network elements and resale. If Congress believed, as MCI asserts, that arbitrage was not a problem because retail "prices are set by market forces," MCI Br. at 25, then Congress would not have specified that wholesale prices were to be discounted from retail rates rather than based on cost as it required for network elements, interconnection, transport, and termination. Congress specifically chose to rely on discounted retail rates because such rates would "reflect whether, and to what extent, the local dialtone service is subsidized by other services." House Rep. at 72. Moreover, the Act sets no timetable for states to eliminate implicit subsidies, and, more than two years after passage of the Act, no state has abandoned such subsidies or even begun a proceeding to do so.[19]

[19] The FCC's elimination of the unbundling/resale distinction also subverts the statutory scheme by permitting competitors to evade the Act's express restriction on the joint marketing of resold local services. Congress sought to create a competitive balance by preventing large long distance carriers from jointly marketing their services with local service acquired from an incumbent Bell operating company under the statutory resale provision *until* that incumbent is authorized to provide long distance service in its home region. *See* 47 U.S.C. § 271(e)(1). This section is intended "to provide parity between the Bell operating companies and other telecommunications carriers in their ability to offer 'one stop shopping' for telecommunications services." S. Rep. No. 104-23, at 43 (1995). But, as even the FCC concedes, an entity providing service through the use of unbundled network elements will not be subject to the joint marketing restriction (presumably because Congress expected such an entity to be engaging in a degree of facilities-based competition rather than simply reselling by another name). Pet. App. 246a (Order ¶ 335). In this respect as well, the FCC's elimination of the limitations on unbundled network elements undermines the statutory structure Congress created.

D. The Combination Rules Invalidated by the Court of Appeals Were Contrary to the Terms of the Act and Were the Final Step in Eliminating Any Distinction between Unbundled Network Elements and Resale.

Even after the FCC had expanded the scope of network elements and rejected any consideration of whether a competitor truly needed to obtain such elements from the incumbent, one difference between the use of unbundled network elements and resale should have remained: With resale, a competitor acquires use of an incumbent's network as a single, assembled service, whereas with unbundling competitors are entitled only to individual elements and must assemble those elements into a functioning network and business themselves. But the FCC did away with this distinction as well. Consistent with its unswerving determination to favor competitors over incumbents in every manner, the agency decreed that incumbents must provide "unbundled" network elements in a prepackaged, combined form whenever a competitor requests. 47 C.F.R. §§ 51.315(b)-(f). Coupled with the FCC's removal of any limits on what pieces of an incumbent's business must be provided as network elements, these combination rules would permit competitors to buy use of an incumbent's *entire* network as a preassembled and preconfigured "UNE platform," under the cloak of unbundled network elements.

The court of appeals rejected this result. As it explained, "[t]o permit [the] acquisition of already combined elements at cost based rates for unbundled access would obliterate the careful distinctions Congress has drawn in subsections 251(c)(3) and (4) between access to unbundled network elements on the one hand and the purchase at wholesale rates of an incumbent's telecommunications retail services for resale on the other." Pet. App. 71a. Under the FCC's rules, new entrants could provide exactly the same services through either unbundled network elements or resale, depending on which price would be most advantageous to them.

The lower court's ruling was compelled by the plain text of section 251, which requires incumbents to provide "*unbundled* network elements in a manner that allows *requesting carriers to combine* such elements in order to provide a telecommunications service." 47 U.S.C. § 251 (c)(3) (emphasis added). This statutory language is entirely consistent with the role that Congress expected unbundled network elements to play. Because Congress intended that incumbents be required to unbundle only the limited number of bottleneck facilities that competitors themselves could not reasonably duplicate, it fully expected that competitors would have to take those individual elements and "combine" them with their own facilities in order to design and construct their own networks. The FCC, having already removed other limits on the nature and use of network elements, disregarded this statutory directive as well and required incumbents to provide network elements to competitors on a precombined basis.

The court of appeals' invalidation of the FCC's combination rule provides a bulwark against the total elimination of Congress' distinction between unbundled elements and resale. Requiring competitors to combine elements, as the statute commands, helps to preserve resale as a distinct option despite its often less advantageous pricing: By choosing resale, a competing carrier can avoid spending the resources and taking the risks that inhere in designing and constructing a network through the combination of individual facilities. Allowing competitors effectively to obtain an incumbent's entire, already-combined network in the guise of unbundled network elements would absolve competitors of the risks associated with selecting and paying in advance for particular facilities and designating the "points" on the incumbent's network where they require access.

Petitioners try to sidestep the clear statutory language of section 251(c)(3) by contending that "unbundled"

means merely offered at separate prices. *See, e.g.*, FCC Br. at 44-45; AT&T Br. at 38-42; MCI Br. at 18-20. And they claim the statutory language assigning an incumbent's competitors the responsibility to "combine" elements simply requires that incumbents not restrict competitors from combining elements obtained from incumbents with other elements. *See, e.g.*, MCI Br. at 22. Thus, Petitioners effectively assert that Congress meant sham unbundling to be a lower-priced version of resale and intended no meaningful distinction between sections 251(c)(3) and (c)(4) of the Act.

Even taken on its own terms, this argument fails to make sense of the FCC's rules. Normally, the sum of the prices for individual pieces of a package is at least equal to (if not greater than, because of lost efficiencies) the price for the package as a whole. Indeed, if that were not the case, a purchaser would never have any reason to buy the package. But the FCC has given new entrants not only the right to obtain pieces of an incumbent's network at separate prices, but the right to obtain *all* the pieces of the network at a total price that will often be far *less* than the price that Congress designated for the whole. Congress dictated that the price for use of the entire network must be based on retail rates, which includes support for universal service subsidies. Under the FCC's vision of unbundling, competitors can obtain use of the same network—on a preassembled basis—at a price equal to the sum of the cost-based rates for each element, which do not include any universal service subsidies. That is obviously not what Congress intended.

Indeed, even under their own definition, petitioners truly seek to turn the concept of "unbundling" on its head. Requiring incumbents "to offer [unbundled] elements for *individual* leasing at *individual* prices," FCC Br. at 44 (emphasis added), protects new entrants by preventing an incumbent from forcing an entrant to take the whole

network or a package of elements, rather than only the individual pieces the entrant needs. Petitioners utterly pervert this justification by insisting that the "unbundling" provisions give them the right to obtain an incumbent's *entire* network as a preassembled whole.

In any event, taking petitioners' argument on its own terms is too generous, because it cannot be squared with the language that Congress used. Although "unbundled" can mean in part "separately priced," the language and structure of the statute as a whole demonstrate that Congress intended "unbundled" also to mean "physically separated." Petitioners improperly ask the Court to consider the term "unbundled" in isolation from the remainder of the statute. *See Bailey v. United States*, 516 U.S. 137, 145 (1995) (a court must "consider not only the bare meaning of the word but also its placement and purpose in the statutory scheme"). In particular, petitioners ignore or deny any connection between the term "unbundled" and the use of the word "combine" in the same sentence of the same subsection. *See, e.g.*, FCC Br. at 44-45; AT&T Br. at 38-42; MCI Br. at 21-22. But section 251(c)(3) requires that an incumbent "*shall provide* such unbundled network elements *in a manner* that allows requesting carriers *to combine*" the elements. That statement necessarily presupposes that the provided elements are not already combined. It would make no sense to say that the incumbent's duty is to provide network elements in a manner that allows entrants to combine them unless Congress intended the entrants to have the responsibility to do the combining. Congress expressly understood "unbundled" to require not only separate prices, but physical disconnection.

Indeed, until it resorted in its brief to this post hoc rationalization that is "entitled to little deference," the FCC itself had always understood that unbundling has a physical component. *See Securities Indus. Ass'n v. Board*

of Governors of the Fed. Reserve Sys., 468 U.S. 137, 143 (1982). In its Order, the FCC explained that " 'access' to network elements 'on an unbundled basis' means that incumbent LECs must provide the facility or functionality of a particular element to requesting carriers, *separate from the facility or functionality of other elements, for a separate fee*." Pet. App. 226a (Order ¶ 268) (emphasis added). In other words, unbundling involves not simply a "separate fee," but separation from "the facility . . . of other elements." Similarly, in discussing the feasibility of unbundling loops that were delivered in an aggregated form by an integrated digital loop carrier ("IDLC"), the FCC stated that "[*o*]*ne way to unbundle* an individual loop from an IDLC is to use a demultiplexer *to separate the unbundled loop(s)* prior to connecting the remaining loops to the switch. Commenters identify a number of other methods for separating out individual loops from IDLC facilities . . . ." J.A. 73 (Order ¶ 384) (emphasis added); *see also id.* at 247-48 (Third Order on Reconsideration ¶ 44) ("Although we conclude that shared transport is *physically severable* from switching, incumbent LECs may not unbundle switching and transport facilities that are already combined, except upon request by a requesting carrier." (emphasis added)).

Petitioners' own comments on the proposal that led to the FCC's Order reflected the same understanding. The Department of Justice, for example, noted that, "[i]n jurisdictions which have begun to open up local markets by requiring the *unbundling* of the local network into the loop, . . . local switching, and interoffice transport elements, a variety of problems have developed in *separating* a customer's loop . . . from the local switch." Reply Comments of the Department of Justice, CC Docket No. 96-98, at 28 n.33 (May 30, 1996) (emphasis added); *see also* Comments of MCI Corp., CC Docket No. 96-98, at 13 (May 16, 1996) ("To the extent an ILEC itself has the ability to separate its network into elements and sub-

elements . . . this demonstrates the technical feasibility of providing those unbundled elements or subelements.")

Petitioners' remaining arguments as to why the Court should ignore Congress' clear directive that "requesting carriers [are] to combine" unbundled network elements are equally unavailing. Petitioners contend that incumbents must provide competitors with network elements in a combined form when those elements are already combined in an incumbent's network in order to ensure "nondiscriminatory access." *See, e.g.*, FCC Br. at 46; AT&T Br. at 35-36; MCI Br. at 20-21. But this argument treats incumbents as though they merely stumbled on their networks already constructed and combined. Of course, it was the incumbent that did the work and spent the money to design a network and combine the individual elements that comprise it. Accordingly, requiring incumbents to hand those preassembled networks over to their competitors is the rule that violates the standard of nondiscrimination. Such a rule discriminates in favor of the competitors by relieving them of the need to combine elements in a network of their own design—the very tasks that the incumbents had to complete before they could provide service.

Finally, Petitioners engage in word games by suggesting that the court below somehow transformed the incumbents' "duty" to provide access to unbundled network elements into a "right . . . to disconnect those elements." *See, e.g.*, FCC Br. at 45-46. The court of appeals' interpretation simply defines the scope of the incumbents' duty: They must provide access to individual, disconnected network elements. The FCC is simply wrong in suggesting that the "grammatical implication of the Eighth Circuit's construction . . . is that incumbent LECs *must* provide access to network elements . . . *only* on a *disconnected* basis." *Id.* at 46 (emphasis in original). Although incumbents' duty is limited to providing access to

individual, unbundled elements, they obviously may go beyond their duty and provide combinations of elements if they so choose.

* * * *

Taken together, the FCC's unbundling rules create a regime entirely foreign to the statutory language, structure, and purposes. In its eagerness to help competitors instead of promoting meaningful competition, the agency rejected Congress' vision of unbundling as a limited option to obtain physical network elements that new entrants need to compete and cannot reasonably build or acquire elsewhere. In its place, the FCC substituted a broad right of cost-based access to virtually every part of an incumbent's business on a precombined basis. The FCC's regime discourages the development of facilities-based competition by eliminating any incentive for a new entrant to invest in rival facilities. It also undermines the foundation of universal service support by encouraging new entrants to engage in regulatory arbitrage and depriving incumbents of the revenues needed to support below-cost prices that they still are required to offer for some services. Petitioners' reliance on *Chevron* thus rings hollow. In determining whether an agency is entitled to deference, courts must "look to the provisions of the whole law, and to its object and policy." *John Hancock Mut. Life Ins. Co. v. Harris Trust and Sav. Bank*, 510 U.S. 86, 94-95 (1993). By that measure, the FCC's unbundling regime cannot stand.

II. THE FCC'S "PICK-AND-CHOOSE" RULE FURTHER ERODES THE ACT'S RELIANCE ON BASIC MARKET PRINCIPLES IN FAVOR OF REGULATORY FIAT.

As the court of appeals recognized, the FCC's "pick-and-choose" rule—under which a competitor can pick for itself at any time (even after it signs an agreement with the incumbent) any term from any of an incumbent's prior or subsequent interconnection agreements—further undermines the statutory structure Congress created. The

rule again exemplifies the FCC's determination to aid new entrants even if the results are contrary to the structure of the Act.

Section 252 is designed to encourage carrers to set the terms and conditions of interconnection and the purchase of network elements and wholesale services through private commercial negotiations. On receiving a request under the provisions of section 251, "an incumbent local exchange carrier may negotiate and enter into a *binding agreement* with the requesting telecommunications carrier" that governs the rates, terms, and conditions of the requesting carrier's purchase. 47 U.S.C. § 252(a)(1) (emphasis added). Both an incumbent LEC and an interconnecting competitor have an explicit duty to negotiate in good faith. 47 U.S.C. § 251(c)(1). They may bargain "without regard" to the Act's pricing, technical, and quality requirements, and a state must approve a negotiated agreement even if it departs from those requirements as long as the agreement is nondiscriminatory and consistent with the public interest. 47 U.S.C. §§ 252 (a)(1), 252(e)(2)(A).

The broad freedom of incumbents and competitors alike to settle voluntarily on the terms and conditions of their interconnection is "[c]onsistent with [Congress'] intent that carriers be encouraged to negotiate and resolve interconnection issues" and reflects Congress' recognition that, in order to reach commercially acceptable agreements, parties must have the flexibility to make tradeoffs and tailor agreements to their particular circumstances. S. Rep. No. 104-23, at 20 (1995). The statutory scheme is "intend[ed] to encourage private negotiation of interconnection agreements." *Id.* at 19. Bilateral negotiations can take into account the economic and other conditions that differ widely from place to place and between pairs of parties, enabling interconnecting carriers to reach arrangements that serve them most efficiently and, under competitive conditions, serve the public interest as well.

The FCC's Order effectively wipes out this statutory scheme. It precludes meaningful negotiation of binding agreements by allowing new entrants "to choose among individual provisions contained in publicly filed interconnection agreements" that incumbent LECs have reached with other carriers. Pet. App. 254a (Order ¶ 1298). Competitors may poach "any individual interconnection, service, or network element arrangement contained in any agreement to which [the incumbent] is a party." 47 C.F.R. § 51.809(a). What is more, a competitor may demand any such term for itself at *any* time, even after it has already signed a contract with an incumbent agreeing to a full package of terms and conditions. *See* Pet. App. 264a-65a (Order ¶ 1316). The competitor need not enter into renegotiations that would give the incumbent a chance to rebalance the relationship to take account of the terms imported from other agreements. Rather, the Order lets the competitor bypass the statutory negotiations *entirely* and demand that a state regulator award it any term agreed to by others. *Id.* at 267a (Order ¶ 1321).

This "pick-and-choose" regulation cannot be reconciled with a statutory scheme that relies on bilateral commercial negotiations to establish "binding agreement[s]," 47 U.S.C. § 252(a)(1), and emphasizes reliance on private negotiations. Bargaining is impossible if one party remains free to avoid its promises by selecting new contract terms at will, and the other party cannot know the extent of its commitments because it cannot know to whom else it will be forced to extend each isolated concession that it makes. And any agreements that are concluded under the "pick-and-choose" rule are not binding. A contract that gives one party unfettered discretion "to deny or change the effect of the promise, is an absurdity." *United States Trust Co. v. New Jersey*, 431 U.S. 1, 25 n.23 (1977).

"Pick and choose" distorts the content of interconnection arrangements as well. A complex commercial agreement is an integrated whole whose terms reflect the give

and take of bargaining. Generally, each party makes concessions in some areas in exchange for benefits in others, reflecting the particular needs and priorities of the parties. A party might, for example, agree to a higher price for one service in exchange for a lower price for another. But "pick and choose" allows one side (the new entrant) to demand the *quid* (the lower price on the first service) without having to take the *quo* with which it was originally paired (the higher price on the other)—regardless of differences in context or in the commercial assumptions on which each bilateral arrangement is based.[20] Given this prospect, an incumbent simply cannot afford to make tradeoffs, and a negotiated agreement that would benefit the negotiating parties will not be reached. The individualized, negotiated agreements Congress envisioned are replaced by "one size fits all" agreements similar to the tariffs that have long pervaded telecommunications regulation.

This preclusion of meaningful negotiations is exacerbated because competitors may pick and choose even from agreements negotiated before the 1996 Act was passed—which most frequently were agreements of convenience between neighboring incumbent LECs under which they handed off calls to each other at the borders of their contiguous territories, often at no charge. *See* Pet. App. 267a-68a (Order ¶ 1322); J.A. 23-24 (Order ¶ 162). By creating a regime in which one party at the bargaining

[20] The FCC did provide incumbents with the option of grouping terms it could "prove" were "legitimately related to the purchase of the individual element being sought." Pet. App. 264a (Order ¶ 1315). But such compartmentalization ignores the reality that a complex commercial agreement involving multiple elements and services must be viewed as a whole—one party may accept a tradeoff that it believes to be somewhat disadvantageous on one element because a tradeoff for another element that is a subject of the same agreement is particularly advantageous. And forcing an incumbent to disclose this type of detailed analysis during negotiations in order to be able to prove later that such a link is "legitimate" or that particular terms were "expressly" linked, AT&T Br. at 50, would have its own chilling effect on negotiations.

table can force the other to comply with terms designed for entirely different circumstances, including even no-charge terms from previous agreements of convenience, the FCC has corrupted Congress' design and ignored its decision to rely on and give maximum effect to private commercial negotiations among carriers.

The FCC tries to ground the "pick-and-choose" rule on section 252(i) of the Act, which provides that a "local exchange carrier shall make available any interconnection, service, or network element provided under an agreement . . . to which it is a party to any other requesting telecommunications carrier *upon the same terms and conditions* as those provided in the agreement." 47 U.S.C. § 252(i) (emphasis added). But the "terms and conditions" of an interconnection contract include all the terms and tradeoffs in the agreement, not separate subsets of terms. Section 252(i) means only that prior interconnection agreements must be made available *as integrated wholes*, so that a second entrant can step entirely into the shoes of an earlier one.[21] The FCC's contrary reading would negate the negotiation scheme established in the remainder of the statute and is therefore not entitled to *Chevron* deference.[22] *See Chevron*, 467 U.S. at 843 n.9;

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[21] The FCC's suggestion that such a rule would encourage incumbents to lard an interconnection agreement with unrelated terms, FCC Br. at 49-50, ignores the fact that any agreement must be approved by a state commission under a broad public interest standard. 47 U.S.C. § 252(e). Accordingly, any attempt to include unrelated terms in an interconnection agreement would subject it to rejection by the state commission.

[22] The FCC's construction of section 252(i) is also a reversal from how it has previously interpreted similar nondiscrimination obligations, which provides further reason to accord it little deference. *See, e.g.*, *INS v. Cardoza-Fonseca*, 480 U.S. 421, 446 n.30 (1987). For example, the FCC has long required AT&T to serve any requesting customer under a filed interstate tariff, so that AT&T cannot discriminate among customers. In the 1980s, when AT&T sought to offer certain large customers individually tailored packages of interstate services, the FCC allowed AT&T to file a special tariff

NationsBank v. Variable Annuity Life Ins. Co., 513 U.S. 251, 256 (1995) (agency interpretation must be "reasonable in light of the legislature's revealed design").

CONCLUSION

For these reasons, the FCC's unbundling rules and its "pick-and-choose" rule should be vacated in their entirety.

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listing each tailored package as a separate tariff option. The FCC required AT&T to allow other customers to buy its services under this tariff, but only if the customer would purchase the entire integrated bundle of services offered under the option; the customer could not just pick and choose individual terms. The FCC ruled at that time—in direct contrast to what it concluded here—that integrated packages of services necessarily involve tradeoffs and cannot be pulled apart, and that making these bundles available to all comers *as integrated wholes* is the proper way to satisfy the Communications Act's nondiscrimination requirements. *See AT&T Communications Revisions to Tariff F.C.C. No. 12*, 7 F.C.C.R. 7039, 7040-42, 7044, 7048-49 (Nov. 22, 1991), *aff'd, Competitive Telecom. Ass'n v. FCC*, 998 F.2d 1058, 1062-64 (D.C. Cir. 1993); 47 U.S.C. § 202(a).

APPENDIX

APPENDIX

47 U.S.C. § 153. Definitions

* * * *

(29) Network element—The term "network element" means a facility or equipment used in the provision of a telecommunications service. Such term also includes features, functions, and capabilities that are provided by means of such facility or equipment, including subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecommunications service.

* * * *

(43) Telecommunications—The term "telecommunications" means the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received.

* * * *

(46) Telecommunications service—The term "telecommunications service" means the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used.

47 U.S.C. § 271. Bell Operating Company Entry into InterLATA Services

* * * *

(e) Limitations—

(1) Joint marketing of local and long distance services—Until a Bell operating company is authorized pursuant to subsection (d) of this section to provide interLATA services in an in-region State, or until 36 months have passed since February 8, 1996, whichever is earlier, a telecommunications carrier that

serves greater than 5 percent of the Nation's presubscribed access lines may not jointly market in such State telephone exchange service obtained from such company pursuant to section 251(c)(4) of this title with interLATA services offered by that telecommunications carrier.

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